# The End of Arbitrage, Part II

Imagine for a moment financial markets without asset class allocation. Oh? You want us to do the imagining. That sort of thing is our job, you say? Fair enough. We have amused ourselves so often at the expense of the allocation priesthood it's only right we be required to explain what the world would look like without them.

Not pretty. Even less pretty than the market as we know it. Economists like to talk as if the market were one vast, clear pool of liquidity relentlessly seeking its own level, smoothly equilibrating supply and demand. Oh, yes, occasionally there are splashes, even waves when some big fish takes a leap or a storm blows up, but very quickly the waters flow back in and the surface is leveled.

In real life the market is more like a swamp. There is liquidity and it does tend to seek its own level. But it doesn't flow so much as ooze. There are pools, and streams, but there are also fens and muddy bits and even the occasional islet. The market is segmented not seamless, but the segments are ill defined and shifting. The interfaces between segments are more or less porous. But they are rarely free-flowing or perfectly efficient. All in all, the system is sufficiently clumsy that there is almost always money to be made by arbitrageurs helping liquidity flow around the cloggy bits.

But what if there were no interfaces at all? What if the market, rather than being like a swamp, was instead like a group of tall, waterproof buckets, each labeled by asset class? Depending on the level of abstraction chosen, the labels might read "equities" and "credits"; or "investment grade," "junk," and "distressed"; or "industrials," "technology," "financials," etc. In each bucket there would be an absolutely fixed amount of liquidity, with no inflow or outflow. No matter how tantalizingly close together the buckets were placed, there would be no way to shift liquidity from one to the other. Finally, imagine that other market events, such as new issues or bankruptcies, continued unconstrained.

The "distressed credits" bucket might contain, say, 300 gallons of liquidity, or $300 billion, representing the total fixed-dollar demand for distressed loans. But the supply of distressed credits—their total displacement if you will—can vary. And it does. Enron, WorldCom, Global Crossing, and their ilk (and they had a lot of ilk) all go broke. Compared to all the debt in the world, let alone all the financial assets in the world, even these massive defaults don't amount to much. But the supply of distressed debt in the bucket goes up 50 percent. And because the dollar demand is fixed, all inside that one bucket, the price, the liquidity per unit, must fall by a third. And it must stay there until another fundamental shift in supply occurs. There is no "fix" on the demand side because liquidity cannot flow in or out of the bucket. Meanwhile in some other bucket, say, "investment

**INCEPTION SHARES ***
**Net Returns**

| | MTD | YTD |
|---|---|---|
| **STATISTICAL** | | |
| ONSHORE | 1.57% | 1.72% |
| OFFSHORE | 1.57% | 1.70% |
| **CONVERTIBLE** | | |
| ONSHORE | 1.33% | 7.73% |
| OFFSHORE | 1.33% | 7.74% |
| **HEDGED HIGH YIELD** | | |
| ONSHORE | -0.52% | 7.93% |
| OFFSHORE | -0.53% | 7.90% |
| **DIVERSIFIED CONVERTIBLE** | | |
| ONSHORE | 1.99% | 3.22% |
| OFFSHORE | 1.98% | 3.16% |
| **INTERMARKET** | | |
| ONSHORE | -2.22% | 2.11% |
| OFFSHORE | -2.21% | 2.07% |
| **COMBINED FUND** | | |
| ONSHORE | 0.47% | 5.05% |
| OFFSHORE | 0.47% | 5.06% |

* Limited Partner returns may vary depending on the timing of investment. Please refer to your individual monthly statement.

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grade," just the opposite is happening: supply is shrinking as ratings fall, but liquidity remains constant and prices must rise.

Looking down at this market from above, we see not a fitfully efficient equilibrium machine, but a collection of tempests in teapots. Extreme and improbable prices are everywhere being tossed about on shifting waves of supply with no equilibrating response in demand. Inside each bucket traders continue to seek relative mispricings among different securities, but their efforts are overwhelmed by the unchecked tides of supply.

No such market could long endure. Enormous profits would flow to whomever devised a system for shifting liquidity among buckets, no matter how inefficient. So important would be the method of allocating liquidity between buckets that later market historians might actually name the era after the method. And if that old method began to break down as a new dominant mode fitfully emerged, historians might by that sign mark the end of one era and the beginning of another.

The index era ended sometime between the 1998 crash of Long Term Capital and the embarrassment of some of the most profound theorists of indexing and October 2002, the first reasonably durable bottom of the great bust, though perhaps not the last. The era ended because the bubble and the bust shattered the essential articles of the faith that had sustained it: the belief in efficient markets and the presumption that the historic risk-adjusted returns to asset classes were a sufficiently stable foundation on which to rest essentially all portfolio management. It may be many decades before investors can once again serenely contemplate the historic average performance of the U.S. stock market without slipping into waking nightmares of being run down by an outlying event.

In the index era, everybody knew that asset classes, properly defined and efficiently represented, would over time yield risk-adjusted returns in line with historic averages. Everybody knew that practically speaking, and over time, you could both smooth returns and program the risk-adjusted return of your portfolio by allocating capital across a set of efficiently represented asset classes. Everybody knew that there was no return to active management whether in the form of stock picking or market timing. And everybody knew, therefore, that the only service a fund manager could perform was to efficiently represent an asset class at whatever level of abstraction at which the portfolio manager wished to operate.

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Like many things everybody knows, most of these statements were wholly or partly true. But under this system there was one thing everyone did really know. Everyone knew who was primarily responsible for absorbing and ameliorating asset class risk, the risk that in any given period the returns to an asset class would deviate significantly from historic norms. Because efficient market theory says asset class risk cannot be mitigated inside the class, i.e., by security selection, it must be handled at the level of the high priests of Modern Portfolio Theory, the institutional portfolio manager, the asset class level allocator of tens or hundreds of billions in pension funds, endowments, or similar collections of assets. Modern Portfolio Theory is essentially a guide book on how to do that. Managing asset class risk is what Modern Portfolio Management means. The institutional asset allocators were thus also the most important, though not the sole vehicles, for shifting liquidity across market segments, the swiftest flowing streams through the swamp, the biggest pipes between the buckets.

Then the bubble burst. And asset class risk was orphaned. To hell with historic norms. Nobody wanted ever, ever to be caught holding the ball through another outlying event.

Strictly speaking, of course, the parents aren't dead. But they do show an increasing inclination to send the children off to one of those far away boarding schools that have long been the repository of the troubled children of the rich. With the children ensconced, the parents can comfort themselves with the thought that the tikes are in the hands of caring specialists who will do for the children what the parents would if they could, only better.

Right.

In financial markets today we call those boarding schools hedge funds. The current flow of institutional capital away from traditional managers and toward hedge fund managers means one thing: the institutions are disowning asset class risk. So they are firing guys who made their living as asset class representers—i.e., index huggers—and hiring in their place managers whose specialty has been making asset class risk disappear, or at least diverting it away from their investors.

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It is not going to work. It is true that during the index era, hedge funds, broadly construed, played an extremely important equilibrating function, not so much by trading against the prevailing categories as trading outside them. But the hedge funds' contribution to equilibrium was largely a function of their rejection of the prevailing dogmas. Indexing and all the dogmas of MPT are essentially stratagems for getting around the need to think, avoiding the possibility of human, in this case manager, error. Hedge fund managers, on the other hand, are mostly guys who think they can think.

The paradigmatic hedge fund of the era was not "officially" a hedge fund at all. Berkshire Hathaway's independence, its contrariness, its leader's insistence that the dogmas of indexing were financially and even morally bankrupt, its willingness to set its own standards for success rather than hiding in the herd, and above all Buffett's eccentric insistence that thinking works made Berkshire the paradigm for hedge funds because those were the very qualities that rendered Berkshire so relatively immune to market risk. The same qualities make it impossible to imagine Berkshire or its legendary chief running money for Calpers. Independent thought, not the arcana of quantitative strategies, is the essence of market neutrality.

The institutions may imagine they are hiring managers who by some combination of personal independence and tactical skill will be able to invest tens of billions in the same market-neutral fashion that they invested tens of millions. But by the simple act of investing, the institutions will vitiate both the managers' independence and their skills.

Most obviously, arbitrage strategies do not scale. Firms making billion-dollar bets don't resolve arbitrage situations, they create them. More seriously, no matter how loudly the Calpers of the world proclaim they want their new hedge fund managers to eliminate asset class risk, it is hard to imagine the managers actually believing them.

How is Calpers to evaluate their managers if not by comparing the performance of one to another? By thinking deeply about their strategies? By assessing their characters? Bureaucracies don't think and they don't make judgment calls, especially not bureaucracies, which, however unhappy they may be with the results of the bust, still know no other language than MPT, no other truth than that thinking does not work.

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No, the institutions will judge managers based on comparative performance. That means they will need something to compare them to.

The inflow of institutional money will accelerate the trend toward organizing the industry for comparability. Even a decade ago there were no useful hedge fund indexes, i.e., no indexes that anyone believed constituted "apples" to which other apples could be compared. There were few conferences. No dog and pony shows at which one youthful manager after another made indistinguishable presentations each designed to reassure the institutional money that the presenting fund was both uniquely skilled and completely predictable.

All of this has been for one purpose: to facilitate gathering assets from institutional clients disinclined to actual thought. When most hedge funds were mostly funded by the manager and a surprisingly engaged and relatively intimate coterie of partners, understanding and conviction were the crucial prerequisites for investing in a fund. Today clients want to compare like to like. But you can do that only if they are alike. You know, like asset classes.

In the index era, the great mandate was "do not under-perform the asset class." In the hedge fund era the new mandate is "never lose money." We are all absolute return guys now. In practice these two radically different standards will prove indistinguishable. In a market in which hedge funds manage trillions of dollars it will be impossible for them never to have a losing year in aggregate. So in practice the standard will become "never lose money except in the way everyone else is losing it." Hug the index.

Hedge fund investors traditionally invest in "strategies" rather than asset classes, but only as the mounting weight of capital squeezes out arbitrage profits and makes market neutrality an affectation that distinction will evanesce. Hedge fund managers serving institutional clients will come to understand their core job as asset class representation, albeit the classes will sometimes come with exotic names like "volatility," "credit spread," and "term structure."

So powerful are the forces pushing manager behavior in this direction that one wonders whether all along Modern Portfolio Theory was not simply an artifact of the market it purported to rule, the necessary result of the intersection between public securities markets, which sell securities to investors based on astonishingly limited information, and super-wealthy institutions overwhelmed by the job of rationally investing so much money on the basis of so little knowledge. So tasked, we, too, might proclaim the futility of thought.

The ironic result of the current shift of institutional money into hedge funds, alas, may be less thinking than ever. Whatever the limitations of MPT, at least the institutions governed by it were making a non-trivial effort toward addressing asset class risk. Even mechanical rebalancing had salutary equilibrating effects. But when institutions try to hand off asset class risk to firms not actually capable or willing to accept it, the practical end result is that no one thinks about it. The big portfolio managers, once the big pipes between the buckets, no longer want the risks associated with the job. They want hedge funds to do it. But in the very process of trying to hand off the job, they are turning the hedge funds, which used to be little contrarily running pipes making their own special contribution to equilibrium, into more buckets. More buckets, fewer interfaces. Splash. Splash.

Even institutional investors who grasp that they can't simply hand off asset class risk to managers unwilling or unable to manage it will find it more difficult, in the hedge fund era, to re-allocate. Even funds that, like Whitebox, do not impose draconian lockups often penalize flighty investors. Like a roach motel in reverse, investors who get out may not be welcomed back in.

I suspect the core of the problem is that many of the institutional investors now moving capital into hedge funds learned the wrong lesson from the bubble. Because their religion still forbids them from judging market prices, they just cannot pronounce the words "don't buy stupid things." They try and try, but it keeps coming out "don't be net long stupid things." They are absolutely sure that the mechanical decision, as they see it, to be market neutral or sector neutral, is an adequate substitute for making safe and intelligent buys. So they try to hire the arbitrage community to do something that cannot be done at the volumes desired and certainly not for clients whose market power tends to undermine all the qualities that make good hedge funds work.

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Modern Portfolio Theory is not without value. Its great weakness is that the underlying dogmas of efficiency render its practitioners more or less helpless in the face of extreme events since they are forbidden to make judgments about prices. But in normal times MPT makes a real contribution to the job of equilibrating supply and demand.

To the extent that the reign of Modern Portfolio Theory is now breaking up and leaving a vacuum in its wake while the successor regime takes form, asset class allocation is likely to become at least somewhat less efficient for some period of time. The market will tend to look more like our collection of splashy buckets than otherwise. Class and sector mispricing, or for hedge funds "risk factor" and "sensitivity" mispricing, will be both more common and more extreme. In short the payoff to intelligent, idiosyncratic risk-factor allocation will be higher.

What do we propose to do about it? Simple: we are going to actively manage the allocations in the White Box Combined Fund especially to take advantage of these mispricings. We don't expect to re-allocate often, but when we do make a move it will be a strong one.

Both the changing environment and the evolution of Whitebox favor this development. Given the breadth of our activities, we are well positioned to observe disequilibria across asset classes. That capacity will only increase as we launch additional strategies.

From the beginning we have tried to hire by skill rather than primarily for experience with a class or strategy. As we have grown and undertaken additional strategies, that tendency has strengthened, putting us in a position to re-allocate capital among funds without under-employing key personnel. We can re-allocate capital opportunistically because we are structured to re-allocate talent opportunistically.

Even a year ago, a decision to re-allocate significantly away from stat arb, as we have done, might have been taken as a signal for the stat people to leave the firm, leaving us unequipped for a resurgence of the strategy under more favorable conditions. But with five funds now running, each requiring a mix of skills, we can now think of Whitebox as a portfolio of talent to be invested in the most promising opportunities.

The Whitebox Intermarket Fund, for instance, could not run without the statistical finesse of Jason Cross's team. A few months ago I might have described them as "Jason's team from Stat Arb," but increasingly we simply think of those guys as our quantitative S.W.A.T. team. Of course Intermarket has a qualitative side too. It is a fund of extremes requiring both exceptional mathematical sophistication and as much qualitative and fundamental judgment as any other fund we run. So the natural choice for co-manager (with Jason) was Gary Kohler. Once isolated in a proprietary partnership focused on special situations, Gary's influence is now felt across the firm.

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Rob Vogel runs Whitebox CA as always, and Nick Swenson manages HHY. But from a company standpoint, Rob is our most effective arbitrageur, the best man we have at "isolating the bet," while Nick's particular expertise is distressed credits (or wannabes). Both funds benefit from the talents of each. Meanwhile, if the Intermarket model performs as we expect, it will be a great tool to help us set hedges in Convert and HHY. In both funds the amount of stock we short against the credit varies within a range, the variable being our rough-and-ready view of the fundamentals. Using the Intermarket model to refine that view, we can hedge more efficiently.

For our investors, the upshot is simple. Henceforth, the Whitebox Combined Fund will be much more than an administrative convenience. It will be a strategy in its own right driven by what we believe will be the rising returns to risk-factor allocation and drawing on the supply-and-demand insights that redound to a trading operation that now comprehends most U.S. equity and credit markets.

Andrew Redleaf